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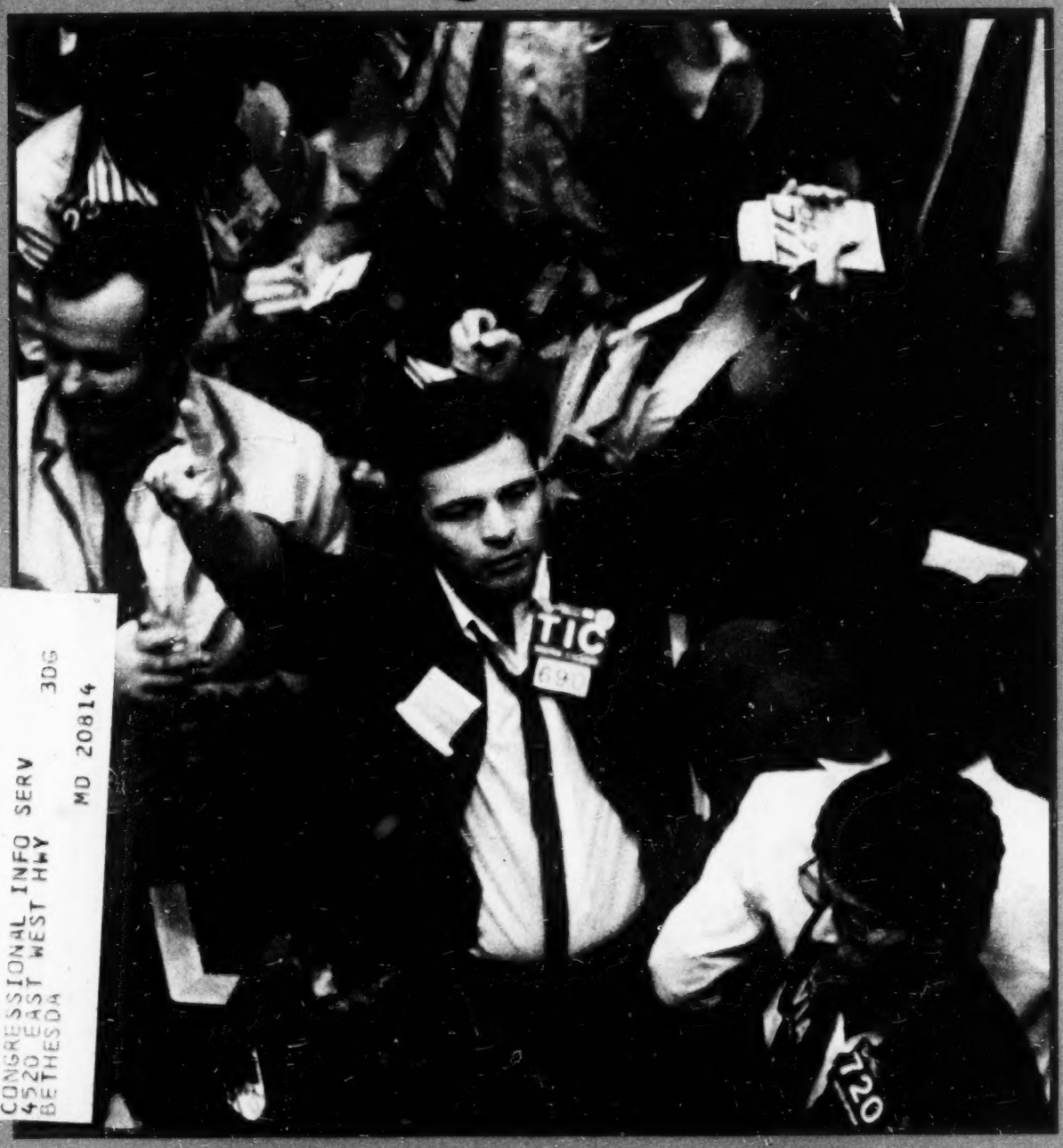
APRIL 1986

Pension World

The Magazine for Plan Sponsors and Investment Managers/ A Publication of Communication Channels, Inc.

Investment Strategies for a Volatile Market



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Index Futures and Index Funds: The New Investment Marriage

Pension World

April 1986
Volume 22 Number 4

The Magazine for Plan Sponsors and Investment Managers/A Publication of Communication Channels, Inc.

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Cover: **The Chicago Board Options Exchange's market maker system requires traders to compete for order flow, as shown here in the S&P 100 (OEX) pit. This competition translates into liquidity in competitive prices. Photo courtesy of the Chicago Board Options Exchange.**

Pension World is published monthly by Communication Channels, Inc., George E. Fowkes, Chairman of the Board; B.J. Kotsher, President; Scott Smith, Secretary; Buford Bryant, Treasurer. Editorial and advertising offices at 6255 Barfield Road, Atlanta, GA 30328. Telephone (404) 256-9800. Telex 4611075COMCHANI. *Pension World* is a registered trademark of Communication Channels, Inc.

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Second class postage paid at Atlanta, GA, and at additional mailing offices. Subscription rates: U.S., 1 year, $41; 2 years, $68; Canada and Mexico, 1 year, $44; Overseas Sea Mail, $59; Overseas Air Mail, $81. Single copies, $3.50. Group rates available. The opinions expressed by authors and contributors to *Pension World* are not necessarily those of the editors or publisher. Articles appearing in *Pension World* may not be reproduced in whole or in part without the express permission of the publisher. Microfilm copies of *Pension World* are available from University Microfilms, 300 North Zeeb Road, Ann Arbor, MI 48106. Postmaster: Please send form 3579 to Circulation Department, *Pension World*, 6255 Barfield Road, Atlanta, GA 30328.

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ISSN 0098-1753

International equities' dilemma: how do you top 1985?

Equitable's International Fund manager is bullish, but last year will be tough to beat.

Without a doubt, 1985 was a "stupendous" year for international equities and those pension funds which were in on the run-up, which averaged 56 percent, are still counting their cash. But the banner results chalked up last year leave pension managers with an interesting dilemma this year: Has the moment come to cut and run or should they hold fast for further stock gains?

This sharp jump in equity prices presents an even greater dilemma for plan sponsors who have not yet made the leap into foreign equities. Many shied away from foreign investment during the 1981-84 period because of the rise in the value of the dollar and then missed the 1985 explosion. Now they are wondering if a major thrust into international equities would yield profits or run smack into a big correction.

John F. Norris, vice president-pension operations for Equitable, who manages the firm's new International Fund, says the fundamentals of international equities remain strong but he sees no repeat of 1985's performance.

"The performance of the market," explains Mr. Norris, "has created an interesting situation for international fund managers. By no means do we expect a repeat of 1985 performance. We also feel that the fundamentals are very strong and there should be a further increase in foreign equity prices—along with some periods of declining prices. In the continental European market, we are in the state of correction from the peaks which were reached in early 1986."

Mr. Norris stresses that the overall fundamentals continue to be strong for all equity markets. He says that the reduction in oil prices is very bullish for both real growth and low inflation in the major industrialized countries. It is also helpful to other oil importing countries. The estimated impact on real growth is anywhere from one-half to one percent in real growth over and above what would have happened if oil prices had remained where they were.

"The impact on inflation also ranges from one percent to two percent," he stresses. "It is quite possible that in low inflation countries like Germany and Japan, there might be a negative inflation. Sharp declines in wholesale prices are expected in 1986, ranging anywhere from five percent to eight percent." As bullish as a fall in oil prices is for the industrialized countries and the world economy, the oil producing countries such as Mexico have serious problems, he says.

Mr. Norris' bullish outlook for international investment does not rest with falling oil prices alone. He sees the U.S. dollar falling further against the hard currencies such as the deutsch mark, the Swiss franc and the yen.

Further, he sees corporate profits increasing in the year ahead. Consequently, with the same price-earnings ratios that existed in early 1986, he sees a possibility of stock prices increasing 15 to 16 percent rather than eight or 10 percent on a local currency basis. On top of that, add three to four percent due to an overall weaker dollar, and it is possible to add between 15 and 20 percent to the price of a stock this year.

Last year was a banner year for foreign equity markets, according to Mr. Norris. The so-called EAFE Index—Europe, Australia and the Far East—rose by 56.8 percent in terms of U.S. dollars and that outperformed the S&P, which was up by 31.7 percent.

"This is the best return that has been recorded," says Mr. Norris. "Most every expert in this area would say that this kind of performance will not be repeated in 1986 or the foreseeable future." Mr. Norris asserts that some of the gains were actually "stupendous," as can be seen in the accompanying table.

Why the big rally in international equities? Mr. Norris says that about half of the 56.8 percent gain in the EAFE Index stemmed from the depreciation of the U.S. dollar against foreign currencies. He says that the European economies have also been in the process of a structural change in the last several years leading to more emphasis on incentives for business and less emphasis on social welfare.

"This has led to a reduction in inflation to levels which have not

by **RONALD DERVEN**
Contributing Editor
New York, N.Y.

"International investment is a widely accepted. . .means of asset diversification. It is only when plan sponsors have the confidence and knowledge of foreign markets that they take seriously their investment in international equities."

—John F. Norris

been experienced in more than 10 years, a pickup in real growth and a substantial increase in corporate profits," he contends. "There is more structural change going on in Europe than Japan....but then more structural change was needed in Europe.

"Money flowed out of the Far East—including Japan—and into Western Europe, particularly the continental markets. And finally, U.S. investors began flooding the European markets with U.S. dollars—particularly in the last half of 1985. This caused a rise in prices which went beyond the fundamentals. It was not uncommon for share prices to rise by five percent or 10 percent in a single day."

The Japanese market, says the Equitable executive, did not do as well in 1985, at least in terms of local currency. It was only up by around 15 percent. Although the sharp appreciation of the yen against the dollar helped the returns in terms of dollars, the lackluster return in terms of the yen stems from the very substantial run-up in prices in 1983 and 1984. Some sectors, such as the banking and insurance groups, doubled or tripled during that period, so by 1985, with stocks overvalued, there was no place for them to go but down.

International Equity Returns—
U.S. Dollar Versus Local Currency
(Capital International Indices)

	12 Months to 12/31/85		5 Years to 12/31/85	
	U.S. $	Local Currency	U.S. $	Local Currency
U.S. (S&P)	31.7	31.7	99.0	99.0
EAFE	56.8	28.0	108.3	N/A
Europe				
United Kingdom	53.4	22.9	85.2	206.3
Germany	140.9	85.9	200.4	274.8
Switzerland	106.9	66.5	107.7	140.9
France	86.9	45.4	87.1	210.0
Italy	135.2	103.3	94.1	249.0
Netherlands	82.3	25.8	151.2	225.3
Belgium	84.2	46.5	183.7	331.3
Norway	70.7	41.9	69.2	175.9
Denmark	62.2	28.3	128.7	238.7
Sweden	58.5	33.9	223.6	459.2
Spain	57.0	29.1	66.7	222.9
Austria	178.7	115.9	88.6	133.5
Pacific Basin				
Japan	43.9	14.6	142.0	138.4
Australia	21.0	48.4	– 2.4	88.8
Hong Kong	51.6	51.3	0.7	54.0
Singapore/Malaysia	– 22.0	– 24.8	– 25.9	– 25.5

Another reason for the less than stellar performance was the increasing threat on Japan's exports by major industrialized countries—particularly the United States. This hit the electronics sector very hard, particularly the semiconductor industry. There were general fears about the impact on the overall economy of a stronger yen.

"Hot" sectors

There are certain industrial sectors which should benefit greatly from falling oil prices, lower interest rates and lower inflation. Mr. Norris says that they include refiners, electric utilities, financial institutions, retail stores and others.

"It will be harder to do well in international investment," he says. "We think that much more attention will be focused on stock picking and selections this year. Fund managers need to pick out issues which have under-performed the market and offer good value in terms of price-earnings ratios and have demonstrated reasons why their earnings should continue to increase."

Large cap stocks

The run-up in foreign markets in 1985, he says, was fueled by the jump in large capitalization stocks. "If one looks at the top five or 10 companies in each of the major markets, you find that they contributed a very substantial portion of the overall rise in the country's equity prices during 1985."

He says for a fund manager to outperform the market in general in 1986, he will have to look beyond the larger cap stocks to more medium- and smaller-sized capitalization issues. "That is where it is going to be very important to have analysts and portfolio managers on site in the country."

He says the best performance in 1986 in the international arena will probably be turned in by active rather than passive management. Although it is difficult to characterize the European markets as a whole, in terms of local currencies Mr. Norris feels they will be up by 10 to 15 percent and in dollar terms by 15 to 20 percent. The French market will likely be one of the better performing markets in 1986. Germany could well experience a correction and then show good gains thereafter.

Political considerations

Asked if there are any political considerations which need to be addressed when investing internationally, Mr. Norris maintains that as long as a plan sponsor concentrates on major markets and major industrialized countries in Western Europe, Japan and the Pacific Basin, there are probably no earth-shaking developments which will occur.

"It is when you get outside of these major industrialized countries that the political situation does become very important," he says. "When you invest in less developed countries, then you are really rolling the dice. We don't recommend investing in exotic countries, at least not for pension plans."

Pension funds

Mr. Norris says that international investment has been heavily used by the large pension funds. But he asserts, interest has been filtering down from the giant plans to the more medium-size plans.

"International investment is a widely accepted and long accepted means of asset diversification," he says. "It is only when plan sponsors have the confidence and knowledge of foreign markets that they take seriously their investment in international equities."

Currently, he says, plan sponsors who are investing internationally are targeting 10 to 12 percent. But many plan sponsors are raising that from 12 to 15 percent. It could reach 20 percent in the next five to 10 years as the foreign markets become more mature and as they deregulate their markets as the U.S. has done.

Mr. Norris sees a tremendous increase in the interest of plan sponsors to invest internationally. In fact, there has been an 80 percent increase in international risk assets in 1985 from $15 to $27 billion—that's pension money invested internationally.

Equitable's funds

Equitable created its new International Fund in 1985 utilizing a multi-portfolio, multi-manager approach to international investing by pension funds. Mr. Norris says that the International Fund combines the regional expertise of prominent overseas investment management firms with Equitable's knowledge of domestic markets. This approach includes exposure to small and medium capitalization companies.

Three separate equity portfolios are included in the International Fund. Two of the portfolios are "region-specific"—one in Europe and one in the Pacific Basin. These region-specfic portfolios focus on small and medium firms. The third portfolio, which invests in both of these regional markets, focuses on large capitalization companies.

Daiwa International Capital Management Co., Ltd. of Japan manages the Pacific Basic portfolio. The company manages over $4.9 billion in assets, with approximately $2.6 billion from non-Japanese clients. Schroder Capital Management International, which has $700 million under management, runs the European portfolio.

Equitable Investment Management Corporation (EIMC), a wholly-owned subsidiary of Equitable, manages the third portfolio. The subsidiary has approximately $7 billion in assets currently under management and has extensive global industry research capability, says Mr. Norris. Equitable itself has over $50 billion in tax-exempt assets under management. □

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